BEFORE THE
CALIFORNIA ENERGY RESOURCES CONSERVATION AND DEVELOPMENT COMMISSION

In the Matter of:

Preparation of the
2005 Integrated Energy Policy Report

Docket No. 04-IEP-1K

COMMENTS OF CONSTELLATION ENERGY COMMODITIES GROUP, INC. AND CONSTELLATION NEWNERGY, INC. ON CALIFORNIA ENERGY COMMISSION DRAFT TRANSMITTAL REPORT

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I. Introduction and Summary

On October 25, 2005, the California Energy Commission ("CEC") issued the *Committee Draft Transmittal of 2005 Energy Report Range of Need and Policy Recommendations* ("Transmittal Report") to the California Public Utilities Commission ("CPUC"). Pursuant to *Notice of Committee Hearing and Availability of the 2005 Committee Draft Transmittal Report*, the CEC invited comments on the Transmittal Report and Constellation Energy Commodities Group, Inc. and Constellation NewEnergy, Inc. (collectively "Constellation") appreciates this opportunity to do so.

In general, Constellation finds the Transmittal Report to provide a wealth of information and documentation that will serve the CPUC's upcoming 2006 Long Term Procurement Process ("2006 LTPP") well. In addition to providing the specific information on the range of need that each of the IOUs must address in the 2006 LTPP, the CEC's expressed commitment to ensuring that the 2006 LTPP is an open and transparent process is a very welcome and necessary element of California's continued progress to workable competitive markets. However, there is one area of concern with the Transmittal Report that Constellation will address in these comments. The concern has to do with the CEC's specific advocacy for the IOUs to enter into new long term contracts despite the fact that other approaches and mechanisms to support infrastructure development are currently under consideration at the CPUC and CAISO.[1] While it is important to ensure that the deployment of new generation resources follows the loading order and encourages new, environmentally beneficial conventional generation, Constellation believes the particular advocacy in the Transmittal Report is premature. Constellation's specific concerns and recommendations in regard to these issues are as follows:

A. Execution by the IOUs of long term power purchase contracts that substitute for rate based generation (or IOU self-build, should that be considered) will perpetuate and prolong the existing hybrid market structure[2] in California, and undermine the effectiveness of competitive market structures, the development of which are already well underway in several CPUC and CAISO proceedings.[3]

B. To the extent that such long term IOU contracts are deemed necessary to address urgent reliability requirements that cannot be met within the competitive wholesale market framework being implemented by the CPUC and CAISO, their scope and duration must be carefully circumscribed to ensure that they do not compromise on the development of the nascent competitive wholesale markets.

C. To ensure that there will not be continued reliance on such contracts to ensure reliability – i.e., in order to ensure that competitive market structures will be successful, steps must be taken to reform IOU procurement practices that lead to such contracts. Specifically, IOU procurement practices should be designed to move increasingly toward full requirements competitive procurement practices in

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[1] See *Transmittal Report* at page 9: "A careful review of the record developed during this proceeding demonstrates that policies encouraging long-term contracts would increase deployment of both new renewable and new conventional generations. Provide a hedge against increasing natural gas prices, and increase environmental and reliability benefits associated with diminished reliance on the state's aging fleet of existing plants." See also page 11: "In sum, the most important action the CPUC can take in the 2006 procurement proceeding is to compel the IOUs to enter into long-term contracts, particularly contracts with renewable facilities. Long-term contracts will encourage development of new conventional and renewable resources, both reducing reliance on aging, less efficient plants and providing important gas-price hedging advantages. The result will be a more reliable market, with environmental and economic benefits accruing to all utility customers."

[2] As used herein, the "hybrid market structure" refers to the continued existence of vertically integrated IOU structures in which a significant percentage of available generating capacity is still owned and operated pursuant to cost-of-service/rate-based regulation. In addition, an additional significant amount of generating capacity is committed to IOU operation via long term Power Purchase Agreement ("PPAs"), the cost recovery of which is assured via rate-based regulation.

[3] *I.e.,* CPUC Docket R.04-04-003 and upcoming LTPP proceeding per D.05-10-031; FERC Docket EL05-146 re MOO reform and RCST capacity backstop contract; and CAISO MRTU effort, with upcoming tariff filing.

which the IOUs procure from the wholesale market the products and services they need to meet their load obligations.

D. Constellation respectfully suggests that the Transmittal Report simply highlight the need to have mechanisms in place to support infrastructure development, without particularly advocating for any single structure or form, particularly since the CPUC and CAISO are in the process of undertaking additional proceedings to complete the Resource Adequacy Requirement mechanism and develop a formalized capacity market structure for California.

E. Constellation respectfully suggests that the Transmittal Report be revised to recognize the impact on retail market competition that will occur due to a failure to anticipate departing loads and the resulting potential over-procurement of resources by utilities.

Constellation raises these concerns only to highlight its views on the impact of IOU procurement practices on the development of competitive wholesale markets (and, in turn, the development of competitive retail markets). The CEC has carefully developed the needs assessment contained in the Transmittal Report, which is a critical element to the upcoming CPUC proceedings. In the upcoming CPUC 2006 LTPP case, Constellation plans to re-introduce the concept of "full requirements competitive procurement" that it first presented in testimony in the last CPUC LTPP procurement docket.[4]

II. Constellation Comments

A. Allowing New Resource Requirements To Be Met Through New Long Term IOU Contracts Of The Traditional PPA Type (Or IOU Self-Build) Will Delay, If Not Preclude, The Development Of Competitive Wholesale Markets.

The stability of wholesale market structures and confidence that regulatory policy changes will not undermine the value of investments is key to ensuring new investments in developing competitive generation assets in California. Such stability will not be achieved, nor will investor confidence develop, if new infrastructure is procured through mechanisms that

[4] *See*, August 6, 2004 Direct Testimony of Constellation Power Source in CPUC Docket R.04-04-003; *See also*, CPUC D.04-12-048, pages 175-176, wherein the CPUC stated that the slice of load concept was to be considered as one of the "second generation" topics.

perpetuate California's currently existing hybrid market structure. Under the existing hybrid market structure, assets (both physical and contractual) that have rate-based cost recovery protection do not compete on a level playing field with assets that do not have guaranteed rate recovery protection. In short, the current hybrid market structure skews market price signals upon which the merchant assets rely for revenues and upon which they rely to incent buyers to execute long term contracts. It is simply not possible to build investor confidence when resource requirements are only successfully developed outside the competitive market structures. Accordingly, Constellation does not believe that the Transmittal Report should advocate new long-term contracts that substitute for rate based generation as a permanent market feature to promote new asset development.

B. Urgently Needed Near Term Resources, Once Identified, Must Be Procured With Special Attention Given To How Those Investments Can Be Managed So As Not To Undermine The Long Term Development Of Competitive Wholesale Markets.

There is no arguing, however, that investor confidence in wholesale market structures will take some time to develop. In contrast, there is concern that California needs new generating capacity in the immediate term. Moreover, today's conventional wisdom holds that a long term contract between a developer and an IOU is the only way to secure financing for new generation resources. Conflicts between these two goals - securing immediate investment, while not undermining confidence in the developing competitive wholesale markets – can and must be managed.

In order to manage these somewhat conflicting goals, the parameters of the specific resources that are urgently needed must be clearly and narrowly defined as to the magnitude and locational requirements, and the contracts that the IOUs enter into must be for as short a duration as possible. Consideration should also be given as to whether any increase in the IOU share of asset ownership (both physical or contractual) necessary to secure the new generation asset development in the near term should be offset by IOU divestiture of a similar amount of IOU owned generation through a competitive offering, so that there is no net change in the current market balance between existing IOU controlled assets (physical and contractual assets) and non-utility assets.

Constellation believes that these issues will be best addressed in the upcoming CPUC LTPP proceeding. Accordingly, the Transmittal Report should acknowledge that the CPUC will be reviewing various "second generation" issues with the intent of creating long-term market structures that will support and encourage development of new generation infrastructure through workable wholesale competition.

C. Shifting IOU Procurement Practices Away From Procurement Of Power Supply Infrastructure To Procurement Of Energy Products And Services Would Eliminate Many Of The Issues That Currently Impede Competitive Investment, Would Shield Ratepayers From Market Risk, And Would Facilitate The Development Of Competitive Retail Markets.

The focus of the LTPP has been to analyze infrastructure requirements necessary for the IOUs to serve their load. Constellation believes that the efforts underway at the CPUC and CAISO will ensure that price signals in the wholesale energy, capacity, and ancillary services markets will lead to infrastructure investment when and where it is needed. Entities that serve load at the retail level should seek the products and services they need to meet their load obligations from the wholesale markets. This is already the case for Electricity Service Providers ("ESPs") and Community Choice Aggregators ("CCAs"). But it is not the case for the IOUs in the hybrid market. Current procurement regulations imposed on the IOUs require them to submit plans to secure assets (both physical and contractual) to serve anticipated load. In meeting those requirements, the IOUs effectively transfer market risks associated with those procurement decisions and investments onto their ratepayers.

Constellation has suggested before the CPUC that the IOUs should offer to wholesale suppliers the opportunity to provide products and services to meet their load obligations, as those load obligations change due to weather, customer switching, load growth, and other factors that influence hour to hour and year to year demand for electricity - rather than being subject to procurement practice regulations that require them to secure specific power supply resources that do not match their load serving obligations. Such procurement practices would move the risks associated with the IOU's current procurement approach away from the IOUs (and their ratepayers) and back to the wholesale suppliers, entities that are in the best position to manage those risks. Such full requirements competitive procurement practices are widespread throughout the Northeast and Mid-Atlantic, and can serve as useful models here in California.

Not only would the full requirement competitive procurement processes serve to shift market risk away from ratepayers, as noted above, it would also help to resolve several of the issues raised in the Transmittal Report. For instance, full requirements competitive procurement practices by the utilities would shift customer attrition risk away from the utilities and thus eliminate one of the key reasons that the IOUs have been reluctant to support customer choice. Furthermore, where these competitive procurement processes have been implemented, the bid evaluation processes are based on one parameter only – price, eliminating many, if not all, the evaluation transparency issues raised in the Transmittal Report. Finally, implementation of these procurement practices by the IOUs would provide a strong measure of support for the development of wholesale markets, rather than conflicting with their development, by assuring wholesale suppliers that there will be opportunities to serve load at a wholesale level through continuous and transparent solicitations.

D. Departing Load Assumptions and the Resultant Resource Procurements Will Negatively Impact Retail Market Development

Constellation does not believe it is appropriate for the Transmittal Report to advance concepts which would undermine retail customer choice. Thus, Constellation takes issue with the Transmittal Report to the extent that it concludes that resource plans should be based upon load forecasts that do not include any departing load, especially given that the study spans through 2016.[5] Even if the DA market suspension is not lifted until the last DWR contract expires in the 2012-2013 timeframe, *some* level of new DA load during 2012-2013 should be assumed. For the CEC to assume no new departing load in the Transmittal Report will likely lead to the IOUs over procuring long-term resources over that timeframe.

Moreover, it is overly simplistic to say that the result of over-procurement is merely economic[6] as the costs associated with the over-procurement will continue to be layered upon future departing customers, presumably as nonbypassable charges, and will have a negative impact on the DA market. To that end, care needs to be taken about how policies for encouraging long-term contracting, or term contracting for urgently needed resources, will affect the retail market. Ultimately, retail markets were envisioned to operate independently of utility cost for bundled customer procurement. However, DWR Contracts have, and will continue to have, an affect on customer choices between retail and utility bundled services. Other contracts may do the same. Thus, it is short-sighted to increase the reliance on utility term contracting without also acknowledging and mitigating the very real cost and retail market structure issues that arise as a result of those policies. Failure to explicitly acknowledge cost treatment now

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[5] *See* Transmittal Report, § 5.2 page 43 in published version (page 40 in on-line version).
[6] *See* Transmittal Report, page 42, citing Hal LaFlash (page 39 in the on-line version).

effectively means that the departing customers will likely carry the burden of a cost obligation for those utility decisions well into the future, undermining any benefits they would otherwise receive from those market structures. Failure to take steps to avoid a new generation of stranded costs will essentially re-create the pre-AB 1890 environment.

It is also disingenuous to say that utility planning uncertainty is resolved solely through the structure of the coming and going rules at the Commission.[7] The CPUC has already provided rules for customer re-entry, six months prior notification, with a three-year stay requirement. Those rules allow utilities to adjust their procurement plans accordingly. To direct otherwise would result in a presumption that the only good utility portfolio is a long-term utility portfolio. By all reasoning and from past experience, relying too strongly either on spot markets or long-term contracts creates a risky profile. If we continue to have utility contracting on behalf of customers and do not adopt the "outsourcing" proposal that Constellation advocates, then utilities should maintain a balanced portfolio of resources which will include some short-term, including spot purchases, some medium term and some long-term contracts. Therefore, with such notice, a utility should, at a minimum, be expected to accommodate both customer migrations and customer returns through a balanced portfolio approach and should be held accountable for such decisions. Constellation does not believe that there is any need to modify the coming and going rules to make them more restrictive for direct access customers.

Rather, customer migration and other attrition risks can best be accommodated through the outsourcing functions espoused by Constellation as in that instance, load forecasting functions are the responsibility of the supplier and the retail market is free to develop absent the additional costs associated with unwise procurement practices.

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[7] *See* Transmittal Report, page 43 in published version (page 40 in on-line version).

III. Conclusion

For the reasons described in detail above, Constellation respectfully asks the CEC to revise the Transmittal Report with respect to its advocacy for long-term IOU contracting.

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Respectfully submitted,

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